

**Remarks of Keith Brainard
NASRA Research Director
to the
Kentucky Public Pension Working Group
Subcommittee on Defined Contribution
September 18, 2008**

Three subject areas:

1. Overall use of DB and DC plans among state and local government and the experience plan sponsors have had with DC plans
2. Myths and misconceptions of DB and DC plans
3. NASRA position on DB and DC plans

Overall use of DB and DC plans among state and local government and the plan sponsor experience

- According to the US Bureau of Labor Statistics, 88 percent of full-time employees of state and local government have access to a traditional pension plan, or defined benefit (DB) plan, as their primary retirement benefit. Most public workers with access only to a defined contribution (DC) plan are employed by local government.
- On a statewide basis, two states provide only a DC plan to broad worker groups: Alaska and Michigan.
 - Since July 1, 2006, all new hires in Alaska, including public school teachers, state workers, and employees of political subdivisions that participate in the AK PERS, may participate only in a DC plan administered by the PERS.
 - Since March 1, 1997, all newly-hired Michigan state employees have had access only to a DC plan.
- Since 2000, Florida, South Carolina, Ohio, Montana, and Colorado have established optional DC plans for broad employee groups as the primary retirement benefit.
- In each of these states, the percentage of those electing to switch from the DB plan to the new DC option, has been relatively small (~ five percent). However, in Florida, South Carolina, and Colorado, the percentage of new hires electing to participate in the DC plan has been higher (15 to 20 percent).
- Ohio offers new hires participating in the PERS and TRS a choice between a DB plan, a DC plan, or a hybrid. From 1/1/03 to 3/1/06, a total of about two percent of new hires elected either the DC plan or the hybrid.
- According to the Government Accountability Office (GAO), approximately 22 percent of state and local government workers participate in an optional DC plan sponsored by their employer.
 - The participation rate of optional supplementary DC plans is significantly higher in cases where the employer provides a match to employee contributions.
 - Anecdotal evidence suggests that participation rates are significantly higher in optional supplementary DC plans, such as in Texas and Virginia, in which an automatic enrollment feature is in place for new hires.
- Several states, including Indiana, Ohio, Washington, Oregon, and Georgia, have established hybrid retirement plans made up of a DB plan and mandatory participation in a DC plan.
 - Indiana has maintained its hybrid structure for substantially all public employees in the state for decades.

- Contributions to the DC component in the Oregon PERS hybrid plan are invested solely in a pooled fund that is invested in the same manner as the big DB plan fund. This strategy reduced administrative costs, reduces investment risk, and provides exposure to asset classes, such as private equity and real estate, that participants may otherwise not be available to individual account holders.
- Participants in the Washington hybrid plan may direct their DC plan contributions to one of a several options, including a fund that mirrors the DB plan fund.
- Ohio and Indiana maintain mutual fund-like investment vehicles for DC (and, in the case of Ohio, hybrid also) plan participants. These vehicles differ from typical DC plans in that values are not updated daily and participants' ability to transfer assets and contributions among fund options, is limited.

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The experience of public plan sponsors with DC plans varies widely and defies brief characterization. Also, fully and accurately assessing the experience of a switch from a DB to a DC plan requires decades of experience, which is not yet available.

Some observations of the state and local government experience with DC plans:

- Of the five percent or so of Michigan state employees who elected to switch to the DC plan in 1996-97, some have continually and unsuccessfully sought legislation permitting them to return to the DB plan.
- The employer actuarial required contribution to the closed Michigan SERS DB plan has increased from 5.6 percent of payroll (\$126.4 million) in FY 98 to 17.6 percent (\$316.3 million) in FY 07, and the plan's funding status has declined from 108.8 percent in FY 98 to 85.1 percent in FY 06. This decline is due to the employer's failure to pay the full required contribution and to investment returns below the assumed rate.
- In Alaska, a memo prepared by the commissioner of the state department that oversees retirement systems, dated March 17, 2008, stated that with respect to the impact of switching to a DC plan on employers' ability to recruit new employees, "[i]t is simply too soon to tell." The memo also indicated that employer contributions are projected to rise "dramatically."
- The actuarial required contribution to Alaska PERS increased FY 05 to FY 07 from 10.72 percent to 13.72 percent.
- Research shows that most workers, particularly new hires, pay little or no attention to their retirement benefit, and little desire exists among workers for employers to switch to a DC plan in lieu of a DB plan. The vast majority of participants who have a choice of retirement plans, do not actively make an election, but rather, default into the plan established as the default plan.
- Nebraska and West Virginia in recent years have elected to switch broad worker groups from DC to DB plans.
 - A 2002 benefits adequacy study of state and county workers in Nebraska found that participants were retiring with inadequate assets on both an absolute basis and relative to their peers in surrounding states. This study was the impetus for legislation to switch new hires to a hybrid, cash balance plan.
 - In 2005, the West Virginia Legislature reopened the DB plan for public school teachers. This plan had been closed to new hires since 1991. The WV legislature found that the DC plan was not reducing employer costs and in response to requests from participants, who contended that the plan was not providing an adequate level of retirement income.

Myths and misconceptions of DB and DC plans

1. A DB plan is more expensive than a DC plan.

The universal law of retirement plan finance:

$$C + I = B + E$$

where

$$\text{Contributions} + \text{Investment Earnings} = \text{Benefits} + \text{Expenses}$$

This law applies to defined benefit, defined contribution, and hybrid plans.

A DB plan is not necessarily more or less expensive than a DC plan, but different plan types will distribute benefits differently.

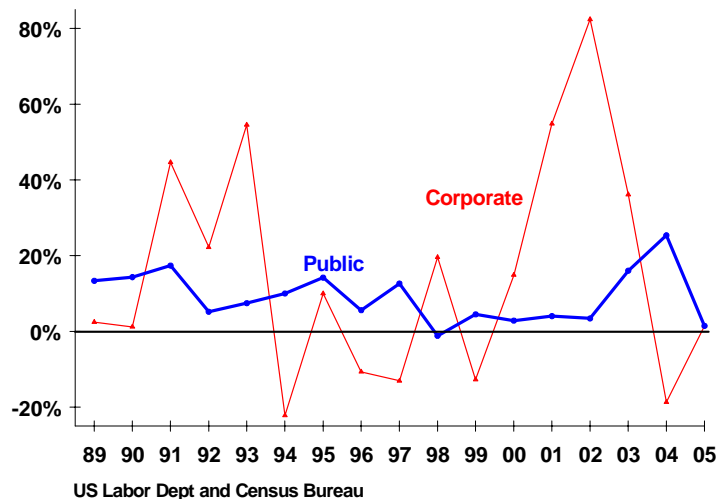
A retirement plan should be designed to meet stakeholder objectives. Typical stakeholders in a public pension plan include employers, taxpayers, participants, and bondholders, each of which has a distinct set of objectives.

2. DB plans outside the public sector have declined in use due to factors that have little or nothing to do with the public sector

DB plans have declined in use chiefly as a result of the effects of ERISA, the body of laws that govern private sector pensions. Primary causes of the decline of DB plans outside the public sector include:

- Cost volatility and uncertainty
- High cost
- Foreign competition

The chart below plots the annual change over the prior year in total pension costs for public and corporate pension plans. As the chart shows, public pension costs are more stable and predictable than corporate plans. This is due chiefly to differences in the way required contributions are calculated.



Pensions sponsored by state and local government are not subject to federal regulations that account for much of this volatility, nor are public pension plan sponsors subject to foreign competition.

3. Closing an existing DB plan to new members does not reduce that plan's unfunded liabilities or cost.

In fact, closing a DB plan usually will increase costs, at least in the near term, resulting from a diminishing payroll base and the loss of new participants available to help fund the cost of the unfunded liability.

4. Public pensions have developed a wide range of portability features.

Such features include opportunities to purchase or transfer service credit, shorter vesting periods and provisions that permit participants to qualify for a benefit without spending a significant portion of their career with the plan sponsor.

This helps to illustrate the point that a plan should be designed with the ends in mind based on stakeholder objectives.

5. Consideration of plan costs should distinguish between pension and retiree health care costs.

These are fundamentally different benefits types that should be considered and evaluated separately.

6. Although some DC plan participants will outperform the market, most will not.

Few professional investors outperform broad market indices, and even fewer amateurs do. Studies consistently show that DB plan investment returns outperform those of DC plans.

Pooling assets promotes higher investment returns through lower costs and professional management, and enables participants to share equally in those returns. Asset pooling can reduce or eliminate certain risks, i.e., pooling reduces longevity risk, which is the risk that a participant will outlive her assets. Pooling also reduces investment risk, i.e., the risk that participants will underperform market indices.

Prepared by Keith Brainard
Research Director
National Association of State Retirement Administrators
512-868-2774
keithb@nasra.org

NASRA RESOLUTION 2003-08 - Support for Defined Benefit Plans

WHEREAS, efforts are underway to strongly influence some state and local governments to offer new or current employees alternative defined contribution retirement plans in lieu of the current state and local government employee retirement system; and,

WHEREAS, parties behind such efforts are often in a position to gain financially from the alternative retirement arrangement, and often forward incomplete and/or biased information to policy makers and employees to further their cause; and,

WHEREAS, state and local government employees traditionally participate in defined benefit plans that provide a guaranteed pension benefit based on years of service and compensation and,

WHEREAS, most state and local government employees already have the option to participate in a supplementary defined contribution plan, such as a Section 457 deferred compensation plan, a Section 403(b) tax sheltered plan, or a Section 401(k) plan, in addition to their defined benefit plan; and,

WHEREAS, many state and local government employers have determined that a defined benefit program is the best means to attract and retain high quality employees by providing stable income replacement in retirement for long-term workers; and,

WHEREAS, many state and local government employers have found defined benefit programs to be the best means for providing ancillary casualty benefits related to disability and death before retirement; and,

WHEREAS, many state and local governments have ascertained that the pooling of pension fund assets in defined benefit programs will provide an optimum mix of growth potential and risk in investments, while providing lower administrative expenses than will typically be the case in counterpart defined contribution plans; and,

WHEREAS, there is already considerable portability within state retirement plans and state and local governments are continuing to expand the features and options within defined benefit programs, including changes to address the issue of short service employees and to enhance portability in order to best accommodate the make-up of their workforce;

NOW THEREFORE BE IT RESOLVED, that the National Association of State Retirement Administrators supports the prevailing system of retirement benefits in the public sector, namely, a defined benefit program to provide a guaranteed benefit and a voluntary defined contribution plan to serve as a means for employees to supplement their retirement savings;

AND, BE IT FURTHER RESOLVED, that the National Association of State Retirement Administrators supports progressive changes within this prevailing system of retirement benefits in the public sector, either within the defined benefit plan or through supplementary plans, that accommodate a changing workforce and better provide many of the features advanced by defined contribution advocates.

Amended Resolution 1998-02
Adopted August 6, 2003